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Identifying And Managing Financial Pressure

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Written by: R. W. Gamble

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INTRODUCTION

This Factsheet is not about being in financial trouble. It's about staying out of it. It's about giving yourself enough lead-time to stay in control and have a say in the decisions that might have to be made concerning your farm business. What can you, as a business owner, do to determine if your business will experience financial pressure in the near future?

One thing you can do is examine the financial health of your business. Just as a production problem is identified by a step wise analysis, a financial pressure point can be identified and corrected by troubleshooting. This Factsheet provides you with the basic steps to help you do that.

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Early Signs - Cash Flow

Most farm businesses become aware of potential financial problems when cash flow starts to become tight. Obligations become increasingly difficult to meet in the short and medium term. This may mean there is a short-term problem (such as a poor growing season) which

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will correct itself in time, or it may mean there is a more serious long-term problem.

There are two concerns for businesses experiencing a cash flow shortage.

- Does the shortage have the potential to cause the business to fail and
- What action can be taken to correct the problem

To deal with those concerns an analysis of several key areas of the business must take place.

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A Quick Analysis Of The Business

While a complete financial analysis is very useful, and in some cases necessary, a quick analysis will answer 3 important questions:

1. Will a current cash flow shortage continue or will there be one in the future?
2. If so, how serious will the cash flow problem be?
3. What is the cause of the problem?

After answering these questions you are in a position to determine what options are available.

Will a Cash Flow Problem Continue or Develop in the Future?
A projected debt servicing worksheet will help to determine if a current cash flow problem will continue or if a cash flow problem will develop in the future.

Debt Servicing Worksheet
A projected debt servicing worksheet will indicate if you have enough cash to cover all your obligations in the coming year. Since you will be using projected figures it is prudent to make both a pessimistic and an optimistic forecast. While you hope for an optimistic outcome, you should be prepared for the pessimistic result.

It is worth noting that while the example in Table 1 uses only cash revenue, some banks include inventories that are available to be sold in the revenue calculation. This is a reasonable approach and you might want to include the value of inventory that is expected to be in storage in your cash revenue projections.

The debt servicing capacity worksheet highlights several key pieces of information:

- The cash inflow from the business
- The reliance of the business on off-farm income or other owners contributions. If you removed this could the business support itself?
- Owners withdrawals - how much is required from the business to cover personal living expenses, taxes and principle payments.
- Reserve for asset acquisition - are you able to replace assets out of current cash flow. In our example the answer is no.

Table 1. Debt servicing capacity	
Projected Year	
+ Farm Cash Revenue	$380,000
- Farm Cash Expenses	$328,000
= Net Cash from Operation	**$52,000**
+ Interest Payments	$18,000
+ Owner's Contributions	$8,000
- Owner's Withdrawals	$42,000
= Cash Available For Principal and Int.	**$36,000**
- Principal and Interest Payments	$31,000
Cash Available After P & I Payments	**$5,000**
- Depreciation or Reserve for Asset Acquisition	$20,000
Debt Servicing Capacity	**(15,000)**

This example shows that there is cash available to cover the interest and principle payments but not enough to cover depreciation. Depreciation or a reserve for asset acquisition is used to replace assets as they wear out. In this example, a shortage of $15,000 exists.

Cautionary Note - Because cash flow takes into account all sources of cash income you can have a situation where an unprofitable farming enterprise is supported by off farm income. There is no cash flow problem but the profitability of the business should be assessed.

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How Serious Is The Cash Flow Problem?

A negative cash flow is always undesirable. Sometimes an expansion or diversification produces a period of cash shortage that corrects itself. As a manager you want to prevent a temporary shortage from becoming a trend. A cash flow shortage that persists is serious because ultimately the shortfall reduces the owner's equity. Equity covers the losses of the business. High equity businesses have the ability to withstand a longer and more serious cash flow shortage because they can re-borrow against their equity.

Knowing your equity position enables you to judge the businesses ability to survive the cash shortage.

To determine how serious this equity erosion might become you should monitor your equity. A second question to answer is do you have a minimum level of equity that you do not want to go below. You may, for example, determine that you will not let your business operate with less than 50% equity. If you know your current position and the projected cash shortfall you can calculate if you will exceed that limit. The following action can be taken to calculate your equity.

1. Calculate your equity by subtracting your total liabilities from your total assets.
2. Divide your equity by your total assets and multiply by 100 and you have your percent equity.

Percent Equity =	**Equity / Total Assets**	**x 100**	
E.g.	**420,000 / 650,000**	**x 100**	**= 64%**

The equity of the business is always stated on the balance sheet, but it can vary widely depending on how the assets are valued. Generally accountants use cost less depreciation to value assets, that is the purchase cost of the asset minus the depreciation taken for tax purposes. Lenders prefer to use fair market value, which is the sale value of the item. It is important to use a realistic figure when valuing your assets. Conservative fair market values should be used in the calculation of your equity.

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Identifying the Causes of a Cash Flow Problem

Any business that is experiencing a cash flow problem must examine the profitability of the business at some point. A business can be profitable and still experience a cash flow problem in the short term. However a business that is unprofitable will, given time, always develop a cash flow shortage. The exception is a business that is supported by off farm income.

Profitability is best measured by net income on an accrual basis. (*See Table 7 for an explanation of profitability.*)

Net income must cover principle payments and personal living expenses including personal taxes. It is easy to see that while a business may produce a positive net income it still must be profitable **enough** to cover these two areas. Many farm businesses are faced with not just achieving profitability, but with increasing their current profitability.

This means they must look at 3 areas:

1. efficiency
2. scale of the business
3. debt structure

Efficiency
Many producers roll their eyes when advisors talk about efficiency, especially in the midst of poor commodity prices. But it is key to answering the question "Is this a short or a long term problem?" If the efficiency of the business is below average, even good prices will not usually generate the profits needed. Efficiency also helps businesses withstand financial downturns.

Efficiency is measured by the physical and economic output of the business. There are no perfect measures of efficiency so it is helpful to look at a combination of physical and economic measurements such as yield per acre or variable costs per acre.

The case study comparison in *Table 2* shows that Farm 1 has a higher cost of producing a dollar of product and a higher percentage of variable costs. While these actual figures may be acceptable depending on the commodity type, for a swine farm this is high. This suggests that efficiency may be a problem.

Scale of the Business
Scale simple refers to the size of the business. One method of assessing scale is by determining the efficiency of the labour usage. This can be compared to other similar operations.

Farms can be too large or too small. In large complex operations, managerial control can be spread too thin. The efficiency of the business suffers as a consequence. Scale problems occur more frequently with farm businesses that are too small. In particular, scale problems occur when the labor supply is large relative to the capacity of the farm to fully employ and support it. Even large, complex farm businesses with several families working together can have scale problems of this sort.

In *Table 2*, Farm 1 has a below average pigs produced per person. There may be too much labour on Farm 1 or the size of the business may need to increase.

Debt Structure
Debt structure refers to the factors that determine the size of your principle and interest payments. These are interest rate, size of the debt, the length of the term and the proportion of short term debt to long term debt. Each of these factors can affect the size of the debt payment required and in turn can impact the profitability of the business.

A farm business can, by failing to use debt capital, limit its size, efficiency, growth, and earning capacity. For the most part however, debt structure problems arise when the debt load is excessive, too costly, or must be paid off over too short a term.

Some debt structure problems are relatively easy to resolve - for example, lengthening loan terms to improve cash flow. Most, however, involve adjusting the asset or liability structure of the business. Farmers might sell assets and reduce liabilities. Or they may simply attempt to eliminate assets that have debt service requirements in excess of their cash-generating potential.

Farm 2 in the *Table 2* case study appears to have too much short-term debt. The percentage of current liabilities to total liabilities at 41.7% suggests that the term on the debt may be too short.

Appendix 7 contains a list of benchmarks for various commodity types.

Cautionary Note - Whenever ratio or financial indicators are used it is important to remember that a ratio outside a normal range is just a flag to prompt you to investigate further. In many cases there may be an explanation for the abnormal figure. Ratios then, cannot be used on their own to diagnose the problem; they only help you to narrow down your search.

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Table 2. Case Study

Case Study Comparison	**Farm 1**	**Farm 2**	
Farm Cash Revenue	$524,000	$330,000	
Farm Cash Expenses	$439,000	$275,000	
Net Cash from Operation	**$85,000**	**$55,000**	
Interest Payments	$35,000	$18,000	
Owner's Contributions	$4,000	$15,000	
Owner's Withdrawals	$68,000	$41,000	
Cash Available For Principal and Interest	$56,000	$47,000	
Principal and Interest Payments	64,000	51,000	
Cash Available After Principle & Interest Payments	**($8,000)**	**($4,000)**	
Depreciation or Reserve for Asset Acquisition	$26,000	$19,000	
Debt Servicing Capacity	**($34,000)**	**($23,000)**	
Net Income (Accrual)	$59,000	$36,000	
Return On Assets	4.9%	9.0%	6.6%
Return On Equity	11.80%	10.0%	6.9%
Financial Strength			
Equity	41.7%	60.0%	63.6%
Financial Efficiency			
Cost of producing $1 dollar of product	$0.84	$0.78	$0.64
Variable Costs as a % of Revenue	83.8%	70.3%	66.7%

			% of Revenue
Scale			
Full time person equivalents	2	1.5	
Pigs produced per person	1,510	1,980	1,850
Debt Structure			
Debt to Asset Ratio	0.58 to 1	0.40 to .1	0.36 to 1
Percentage of current liabilities compared to total liabilities	14.0%	41.7%	26.5%

Benchmarks are taken from the 1999 Ontario Farm Management Analysis Project

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Troubleshooting With A Diagnostic Tree

Figure 1, Financial Troubleshooting Diagnostic Tree, sketches out a tool called a diagnostic tree that helps examine the efficiency, scale, and debt structure of a farm business. The purpose of the decision tree is to provide a step wise procedure for determining if the business is "OK" or "Not OK" in these areas.

This oversimplifies the process, but it demonstrates the interrelationship of efficiency, scale, and debt structure, and the courses of action that might be appropriate to remedy each problem. The choices facing a farm business can vary quite widely. A farm business with acceptable efficiency but unacceptable scale and debt load faces choices that are quite different from a farm with poor efficiency, acceptable scale, and unacceptable debt load. Further, there is always a question of order or priority in attempting to resolve financial problems. Which problem should be fixed first?

Figure 1. Financial Troubleshooting Diagnostic Tree

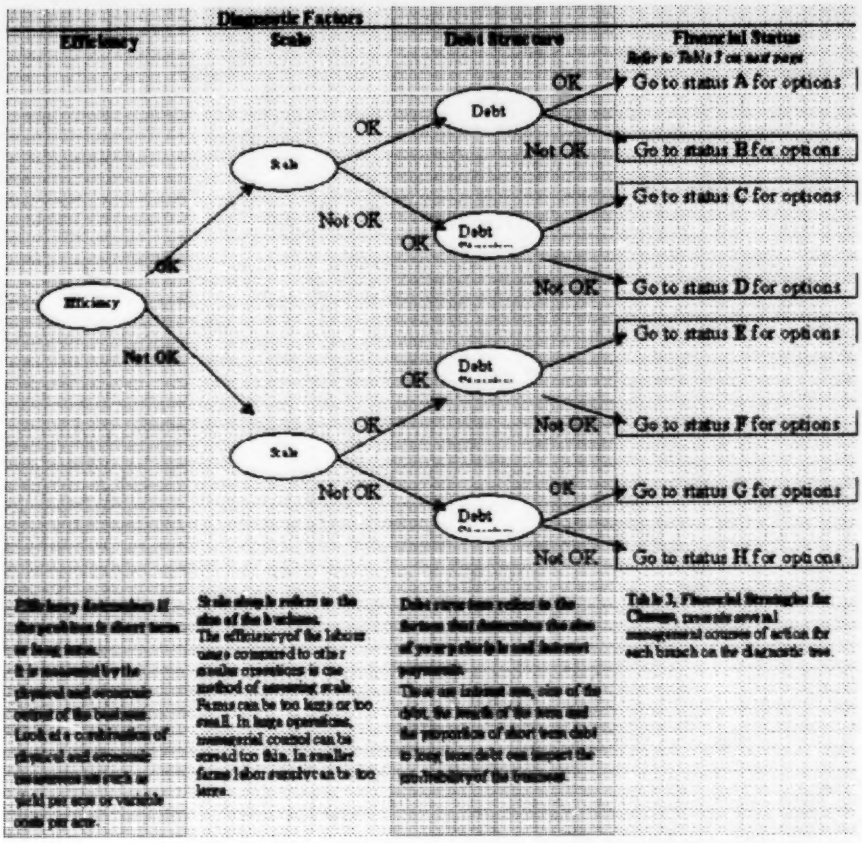

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Table 3, Financial Strategies for Change, presents several management courses of action for each branch on the diagnostic tree. The lists are by no means exhaustive. They simply illustrate ways in which profitability problems might be resolved, given a farm's efficiency, scale, and debt structure.

If you do not want to use the decision tree you can simple use the chart below and then refer to *Table 3*.

	OK	Not OK
Efficiency	☐	☐
Scale	☐	☐
Debt Structure	☐	☐

Table 3. Financial Strategies for Change

Financial Status	Efficiency	Scale	Debt Structure	Strategies
A	OK	**OK**	OK	**1.** Review financial performance annually. **2.** Keep current on new technology. **3.** Examine potential for expansion. **4.** Consider off-farm investments.
B	OK	**OK**	Not OK	**1.** Restructure debt: lengthen term

				or reduce interest rate to improve cash flow. **2.** Sell assets to reduce debt.
C	OK	Not OK	OK	**1.** Address scale problem or else cash flow problems will develop. **2.** Consider the feasibility of adding an enterprise or expanding an existing enterprise. Use records to make expansion decisions. **3.** Investigate custom crop farming or custom livestock feeding. **4.** Examine machinery, labour and other assets to determine if they are fully utilized. **5.** Examine whether management ability and emotional stability are sufficient to handle the additional stress of expansion. **6.** Increase off-farm employment, but assess its effect on efficiency. **7.** Consider retiring, if appropriate.
D	OK	Not OK	Not OK	**1.** Identify several low cost ways to expand, such as renting additional land or facilities, custom feeding livestock, crop-share renting vs. cash renting, or custom crop farming. **2.** Increase off-farm income, but assess its effect on efficiency. **3.** Scale back the farm business to allow a significant increase in off-farm income.
E	Not OK	OK	OK	**1.** Improve enterprise record keeping and analysis. **2.** Re-orient priorities: spend more time on management. **3.** Work to improve and sustain management. **4.** Use advisory services. **5.** Improve marketing skill and performance. **6.** Examine family living expenditures and operating costs. **7.** Evaluate whether the operation is too large to manage efficiently. **8.** Discuss whether to quit farming while equity is still good. **9.** Establish a point where additional credit should not be extended. **10.** Decide if an off-farm job would be better than self-employment.
F	Not OK	OK	Not OK	**1.** Determine if debt problems are due to poor efficiency or outside circumstances. Refer to section E. **2.** Will debt problems develop again if solved now? **3.** Can the business be viable given the debt structure and efficiency?

G	Not OK	**Not OK**	OK	**1.** Determine if farming is a "hobby" rather than a business. **2.** Consider the impact on equity if you continue. **3.** Determine if resources can be employed better elsewhere. **4.** Explore off-farm employment opportunities and preferences.
H	Not OK	**Not OK**	Not OK	**1.** Decide if resolving this difficult situation is a primary goal. **2.** Consider the effects on marriage, family, and health. **3.** Consider selling the business or exiting agriculture. **4.** Refer to above sections B, C and E for suggested actions.

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Some of the suggestions listed above will require that you do further analysis. Appendixes 1 through 7 of this Factsheet provide more detail on how to do that.

- Appendix 1 - Government Programs
- Appendix 2 - Preparing Cash Flow Statements
- Appendix 3 - Financial Analysis Resources
- Appendix 4 - Meeting With Your Lender
- Appendix 5 - Debt Servicing Worksheet
- Appendix 6 - Understanding Financial Terms
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Appendix 1 - Government Program Help

Government assistance programs can reduce cash flow shortages where applicable. If you are preparing a cash flow statement it is important to know the timing of those program payments. The following table outlines what programs are available and when the payments will arrive. For a complete listing of OMAFRA programs, see Programs and Services for Ontario Farmers, Order No. 00-105.

TABLE 4. Government Assistance Programs

Program	Coverage	Timing of Payments
Crop Insurance	• Yield shortfalls resulting from uncontrollable natural hazards, such as frost, hail, drought and flooding. • Available for 53 commercially grown crops • Coverage for unseeded acreage • Reseeding because of an insured peril • Further information at: www.agricorp.com	• usually 4-6 weeks after harvest • See Table 5 for details
Net Income Stabilization Account (NISA)	• All commodities, excluding supply managed, are eligible to participate in the program • Producers can make a base deposit of 3% plus the top up of 1%, meaning that all	• Withdrawals are triggered using a stabilization trigger or a minimum income trigger. • If producer's current year gross

	producers can deposit 4% of their eligible net sales (ENS) annually and receive full matching government contributions (1.5% provincial and 2.5% federal) • Edible horticulture producers are eligible for another top up of 2% bring their total contributions to 6% of their ENS • Producers may make additional deposits of up to 20% of ENS, but the government does not match these deposits. • All producer deposits (matched and unmatched) earn the bonus interest of 3% above the regular interest rates. • Further information at: www.agr.ca/nisa/welcome.html	margin falls below the producer's average gross margin from the previous years (up to five), a withdrawal is triggered. • A withdrawal can also be triggered when a producer's income from all sources falls below $20,000 for an individual or $35,000 for a family plus the current year maximum matchable deposit. • Interim withdrawal - this allows producers to receive their withdrawal entitlement in the same stabilization year as the financial need arises. A producer may request an interim withdrawal application for the 2000 stabilization year once they have received their 1999 Deposit/Withdrawal Options Notice (DWON)(usually by June of each year). • The NISA administration can process an interim payment request within 30 days.
Self-Directed Risk Management (SDRM)	• The Self-Directed Risk Management (SDRM) program operates as a top-up to the Net Income Stabilization Account (NISA) program. The program is available to producers of all edible horticulture crops and maple products. • Producers can deposit up to an additional 3% of ENS for SDRM eligible commodities for which they have not taken crop insurance, to their NISA accounts. This is in addition to the 6% they are eligible for under NISA • 2/3 of the SDRM deposits are matched	• SDRM deposits are part of a producer's NISA account and consequently, withdrawals are triggered on the same basis as the NISA program.

	by the federal and provincial government (i.e. at 2% of the ENS) • for further information look under Risk Management at: www.agricorp.com	
Market Revenue Insurance (MRI)	• The Market Revenue Insurance (MRI) program provides price support to producers of eligible grain and oilseed crops. • The program originated from the Gross Revenue Insurance Program (GRIP) which ended on a national basis in 1995. • MRI pays producers benefits based on historic farm yield, acres enrolled and 2/3 of the difference between the average market price and support price. • The support price is 85% of the 15-year indexed moving average market price as calculated by Agriculture and Agri-Food Canada (AAFC). • Further information at: www.agricorp.com/market.cfm	• Final payments are usually made one year following harvest when the entire crop has been marketed. • Interim payments may be made earlier. • Therefore, for the 2000 crop year, producers would receive interim payments in the spring 2001, a second interim payment in late September of up to 80% of the final payment and the final payment by the end of 2001 • This year, an interim payment for the 1999 crop was made at the beginning of April. • A second interim payment of up to 80% of the final is occurring in late September or early October • Final payments will be made in by the end of 2000. • The exception to this is canola, red spring wheat and winter wheat which has only one interim payment and a final payment in late September
Ontario Whole Farm Relief (OWFRP)/Agriculture Income Disaster Assistance (AIDA)	• The Ontario Whole Farm Relief Program (OWFRP) provides individual whole farm income based assistance to participating producers for losses beyond their control, such as falling	• Farms can access OWFRP benefits once they have completed their respective tax

prices or poor yields.

- All farmers in Ontario that have a valid Farm Business Registration number may benefit from the OWFRP when their farm's 1998 or 1999 gross margin has fallen below 70% of their farm's historical gross margin.
- Further information at: www.gov.on.ca/OMAFRA/english/policy

years and have submitted their OWFRP application forms.

- Farms that have, or are nearing the completion of their 2000 tax year, will have the opportunity to benefit under the 2000 program that is currently being developed nationally. In these cases, producers will most likely have to wait until late 2000 or early 2001 before the 2000 program can provide benefits.

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Table 5. Timing of Crop Insurance Claim Payments

Crop	Harvest Dates / Yields Reported	CI Claim Payment
Soybeans	October	Mid-November
Corn	October	Mid-November
Winter Wheat	July/August	September
Tobacco	Yields obtained after Marketing Board sales	Early Spring
Processing Vegetables	Fall	Payments made at harvest (Fall)
Fresh Market Onions and Carrots	July/August	September
Potatoes	September	October

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Appendix 2 - Preparing Cash Flow Statements

The cash flow projection is an extremely useful management document. Not only does it predict cash shortages, but it also gives you the timing of those shortages. It shows you the specific expenses and revenues have the greatest impact on your business. It will also show you when your credit demands will be the greatest.

The cash flow statement does not monitor the changes in receivables, payables and inventory. These can be reviewed by examining your income statement and balance sheet.

Preparation of a Cash Flow Projection

- A cash flow projection is an estimate of when and where cash inflow and cash outflow will occur in the coming year. It includes cash inflows from farm operations,

- borrowing and non-farm sources,

and all cash outflows from

- farm operating
- capital purchases
- taxes
- family living
- debt payments.

Only cash items are included in the inflows and outflows. Make your projections conservatively. There are two alternatives for preparing a cash flow projection:

Alternative A
To prepare this plan, the records of the previous years are used as a guide and various items are increased or decreased to reflect inflation, changes in acreage or livestock numbers, and capital expenditures.

Alternative B
When previous records are not available or when changes are so great that a new farm business barely resembles the old, it is necessary to start from scratch. Budgets are prepared for each enterprise. These budgets are then molded together with overhead items and family living expenses.

A cash flow projection may be set up for various time periods, usually monthly, quarterly or annually. If an annual one is prepared as a starting point, it can be easily modified to a quarterly or monthly basis.

Monitoring a Cash Flow Projection
The monitoring of a cash flow projection is important. This should be done monthly, quarterly or annually to correspond to the cash flow projection format. Monitoring will reveal marked differences between the actual and the projected.

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Appendix 3 - Financial Analysis Resources

The following is a list of resources that can help you in preparing a cash flow and other useful analysis information.

Ontario Farm Management Analysis Project, Publication 69 - benchmark financial information for various commodities

Farm Financial Analysis and Planning Workbook, Publication 37 - a step by step workbook for completing a set of financial statements.

Computer Tools
Farm Business Analyser - an Excel spreadsheet that analyses your business using the figures from your farm income tax statement. It also allows you to analyse the effects of changing revenue, variable expenses and family living costs on your net income.

Available on the OMAFRA Web site at:
www.gov.on.ca/OMAFRA/english/busdev/agbusdev.html under the heading Computer Management Tools

Farm Financial Analysis and Planning Workbook, Publication 37 - an Excel spreadsheet that has a step by step system for producing a complete set of financial statements including a cash flow, debt servicing worksheet and current and projected income statements.

Available on the OMAFRA Web site at:
www.gov.on.ca/OMAFRA/english/busdev/agbusdev.html under the heading Computer Management Tools

Ontario Farm Management Analysis Project - The OFMAP program files are computer spreadsheet based workbooks with versions tailored to each major farm commodity group. Each workbook contains comparative information based upon averages of farms received by the project. Comparative data is updated when available.
Each program will produce accrual statements. The program has built in calculations to show financial strength, efficiency, and profitability. Enterprise reports show costs and returns per unit of production.

Available on the OMAFRA Web site at:
www.gov.on.ca/OMAFRA/english/busdev/agbusdev.html under the heading OFMAP

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Appendix 4 - Meeting with a Lender

If an analysis reveals that changes are necessary in the business, then you will usually need to meet with your lender. The following are some questions that you should consider before meeting with your lender.

Money-Related Questions
1. Is your information reliable? Can the lender trust your numbers?
2. Have any major changes occurred to the farm operation lately? If yes, have the results been positive?
3. Do you keep up-to-date cost figures? How often are accrual income statements prepared?
4. Do you have enough cash and financing in relation to sales, both now and in the future?
5. Is your equipment in good working order? How much is it worth today?
6. Do you have enough insurance?
7. How have your net income and return on investment compared to others in your industry?

Questions on Assets and Markets
1. What is your marketing strategy?
2. What are the results of this strategy for past years?
3. Are you planning a change to your marketing strategy?
4. What is the current economy like? Has the demand for your product been affected? Is it likely to be affected in the future?
5. What type of inventory do you have livestock, grain and supplies?
6. Is your product mix satisfactory? Should you be adding or dropping products?
7. How does your production of crops and livestock compare to others in your industry?
8. Is new technology making your old equipment less useful?

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Appendix 5 - Debt Servicing Worksheet

Your current **debt-servicing requirement** is the total principal and interest payments you must pay in the coming year.

The **debt servicing capacity** is the ability to pay annual interest and principal after other cash expenses and family living have been paid.

Debt servicing capacity is usually calculated on a cash basis. The exception is the inclusion of crops in storage. Some banks allow these to be included if they are readily available for sale.

Debt is paid from cash flowing into the business. This would include not only farm sources of cash income but also off-farm and personal income. Likewise on the expense side, farm

expenses are not the only requirements for cash. Personal living expenses, income tax and reserve for purchasing assets are also considered.
The charts below outline how you first calculate your debt servicing requirements and then calculate your debt servicing capacity.

Note that liabilities are usually separated into two types, current and term liabilities.

Current liabilities: items that must be paid in the coming year.
Term liabilities: longer-term obligations that require only a portion of the debt to be paid in the current year. This would include accounts payable, property tax arrears, and bank operating loans.

Table 6. Debt Servicing Worksheet

[redacted]

For the Period: **Name:**

[redacted]	Balance Start of Year	Interest Rate	Annual Payments		Balance End of Year
Accounts Payable			**Interest**	**Principal**	
Description					
Total Accounts Payable					
Operating Loan					
Loan Description					
Total Operating Loan		[redacted]			
[redacted]	**Balance Start of Year**	**Interest Rate**	**Annual Payments**		**Balance End of Year**
			Interest	**Principal**	
Loan Description					
Sub Total		[redacted]			
Grand Total					

Total Interest and Principal Payments

Previous Year		Projected Year	
+ Farm Cash Revenue		+ Farm Cash Revenue	
- Farm Cash Expenses		- Farm Cash Expenses	
= Net Cash from Operation		= Net Cash from Operation	
+ Interest Payments		+ Interest Payments	
+ Owner's Contributions		+ Owner's Contributions	
- Owner's Withdrawals		- Owner's Withdrawals	
Cash Available for Principal and Interest	$	**Cash Available for Principal and Interest**	
Principal and Interest Payments		Principal and Interest Payments	
Cash Available after P & I Payments		Cash Available after P & I Payments	
Reserve for Asset Acquisition		Reserve for Asset Acquisition	
Debt Servicing Capacity (the amount available for interest and principal payments on new debt)		**Debt Servicing Capacity (the amount available for interest and principal payments on new debt)**	

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Appendix 6 - Understanding Financial Terms

There are three common terms used to describe financial condition of businesses. They are **liquidity, solvency,** and **profitability**. The following chart outlines the meaning of these terms.

Table 7. Common Financial Terms

Financial Term	Definition	The best measurement	Why worry about it?
Liquidity	Ability of the business to pay short-term liabilities. In broad terms it is the ability of the business to meet its cash obligations within a specific time period. It can therefore be referred to as cash flow. Profitability and liquidity are related concepts-but by no means are they equivalent. Unlike profit, cash flow includes loan principal payments, proceeds from liquidated assets, and family living expenses. Cash flow does not include profitability factors such as depreciation, the value of inventory changes, or capital gains and losses.	• current ratio • working capital • debt servicing worksheet • cash flow statement	Liquidity or cash flow, is the warning signal that says it's time to take a look at the business. Cash flow problems can cause even a profitable business to fail.
Solvency	The ability of the farm business to secure debt or withstand adverse conditions. Sometimes referred to as the ability of the business to pay long term commitments. Solvency is linked to net worth or owner equity. Owner equity serves as a source of security for acquiring debt capital. Or it can simply serve as a potential credit source or a credit reserve to allow borrowing for unexpected events.	• solvency is measured using a balance sheet. • equity • net worth	Solvency indicates the risk-bearing ability or capacity of the business. Solvency or Equity is the factor that determines if you can survive a downturn in your business. Some farm businesses may have sufficient equity to withstand low efficiency for many years.
Profitability	Profit is the return to management, operator labor and equity. In the long run, the farm manager must earn a competitive return on these contributed resources if the business is to continue. In the short run, the farmer must earn sufficient returns to at least pay for variable costs. If this is not possible, then some short-term response to minimize losses will be necessary.	Profit can be measured with an income statement at the farm or enterprise level.	Profitability is the most important determinant of long-term business performance.

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Appendix 7 - Financial Benchmarks

Source: 1999 Ontario Farm Management Analysis Project

Profitability	Dairy	Swine FF	Beef Feedlot	Beef Cow	Cash Crop
Net Income (Accrual)	$75,008	$70,267	$47,824	$25,426	$55,070
Return On Assets	5.3%	6.6%	5.0%	6.1%	4.7%
Return On Equity	5.0%	6.9%	4.3%	6.4%	4.3%
Solvency (Financial Strength)					
Equity	79.7%	63.6%	62.9%	88.0%	70.1%
Financial Efficiency					
Cost of producing $1 dollar of product	$0.60	$0.64	$0.77	$0.52	$0.70
Variable Costs as a % of Revenue	55.5%	66.7%	88.5%	54.6%	50.2%
Scale					
Unit used	Litres of milk sold	Pigs produced	CWT of beef produced	Cows per person	Acres per person
Units per person	198,357	1,850	2,600**	110	850**
Debt Structure					
Debt to Asset Ratio	0.20 to 1	0.36 to 1	0.37 to 1	0.11 to 1	0.30 to 1
Percentage of current liabilities relative to total liabilities	22.6%	26.5%	59.4%	27.4%	32.3%
Debt Servicing Capacity					
Cash available to service additional debt:					
- before accounting for depreciation	-$3,735	-$9,040	-$39,743	$17,242	-$35,485**
- after accounting for depreciation	-$35,676	-$45,231	-$70,993	$5,447	-$75,260**

** *estimated figures*

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This Factsheet was written by: Rob Gamble, Finance and Business Structures Program Lead, Agriculture and Rural Division, OMAFRA, Guelph.

Sections of this Factsheet were modified, with permission, from an Iowa State University

Extension publication called Financial Troubleshooting authored by Robert W. Jolly and Alan Vontalge.

For more information please contact Rob Gamble Finance and Business Structures Program Lead, Agriculture and Rural Division, OMAFRA, Guelph.

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Feedback and technical inquiries to: busdev@omafra.gov.on.ca
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